

## **Stranded Gas Hearings**

(0406161330 Minutes)

### **Gas Pipeline Costs and Tariffs – On behalf of the Port Authority**

*Bill Walker, Attorney at Law, Walker & Levesque and General Counsel for Alaska Gasline Port Authority  
Rigdon Boykin, Attorney at Law, O'Melveny & Myers and Special Counsel for Alaska Gasline Port Authority, June 16, 2004.*

BILL WALKER, General Counsel, Alaska Gasline Port Authority (AGPA); Attorney at Law, Walker & Levesque, LLC, informed the committees that the AGPA was formed in 1999 by the North Slope Borough, the Fairbanks North Star Borough, and the City of Valdez. The purpose of AGPA was to cause a gas line to be built. After formation of AGPA, it applied for and received an IRS ruling stating that only the income to AGPA would be tax exempt. While the application process was occurring, AGPA put together a team to determine the viability of the project. Mr. Walker showed a slide that illustrated that the AGPA project consists of one line and two trunk lines. The main line is a LNG (liquefied natural gas) line to Valdez with a line through Canada on the Canadian Highway route and a line from Glennallen to Palmer to tie into the Southcentral gas grid. The goal is to obtain the maximum distribution of gas throughout Alaska.

MR. WALKER said that AGPA has maintained the premise that a world-class team must be assembled, and therefore AGPA met with the board of directors of Bechtel Corporation in October 1999 to present the concept of AGPA and explained that a cost estimate for the project was necessary. Bechtel Corporation put together a very detailed cost estimate for the project. He noted that Bechtel Corporation was told that with this project, cost overruns couldn't occur. Therefore, Bechtel Corporation built in cost overruns of \$1.8 billion and owner contingencies of \$900 million. Additionally, the corporation was instructed not to assume any infrastructure benefits on the North Slope. Furthermore, 8-10 percent inflation was included as were all the soft costs, such as interest during construction, line pack, insurance, et cetera. The aforementioned has resulted in very complete numbers. Mr. Walker noted that another member of the team is Taylor-DeJongh, Inc., which, for the third year in a row, was voted the number one investment banking oil and gas firm in the world. The information from Taylor-DeJongh, Inc. is constantly updated to provide the best available information. The other member of the team is O'Melveny & Myers LLP.

MR. WALKER informed the committees that the Alaska Gasline Port Authority filed a stranded gas application. However, subsequent meetings with the state indicated that a protocol agreement would be more appropriate, which lead to entering into a protocol agreement and withdrawal of the stranded gas application. Initially, AGPA looked at only an LNG project. He explained that the concept is project finance, which is 100 percent financed with a high debt service coverage ratio. Initially [in 2000], AGPA was advised that the project would require 1.7 and the first run on the LNG went over that. Since that time the "Y" line concept has been added in order to share the costs of the gas conditioning plant on the North Slope and 550 miles of pipe from Prudhoe Bay to Delta, where the "Y" would take place with roughly three lines to Canada and three lines down to Valdez and also the leg over to Cook Inlet. Mr. Walker noted that AGPA has met with Agrium representatives in order to discuss ways in which Agrium could have access to the gas under AGPA's concept. He said that there are approximately four benefits to AGPA's structure, each of which will impact the tariff. Mr. Walker opined that AGPA's structure will provide the lowest tariff with the maximum return to Alaskans. In closing, Mr. Walker highlighted that AGPA has worked with all parties. He mentioned that the benefit of the IRS ruling of the tax exemption is huge because it places what would normally be paid in federal taxes back into the project. Therefore, AGPA's debt service ratios are phenomenal, as illustrated on page 25 of the booklet he provided. Mr. Walker specified that the base case assumes a \$3.75 price in Chicago, a \$2.75 price with the LNG in Valdez. Such a base case would return a wellhead price of \$1.48, which he believes to be fairly significant.

RIGDON BOYKIN, Special Counsel, Alaska Gasline Port Authority; Attorney at Law, O'Melveny & Myers LLP, began by informing the committees that AGPA is not prepared to provide the committee with a tariff today. However, AGPA can inform the committees of the implicit tariff within AGPA's structure. He

explained that the assumption is that AGPA would purchase the gas at the wellhead and sell it to the ultimate consumer. The aforementioned was in response to being told that the project cost too much and that there was no market. The only way to prove whether there is a market is to find a buyer for the gas and determine what that buyer is willing to pay for the gas. From a tax perspective, the assumption provides the maximum bang for the buck. If AGPA owns everything down to the conditioning plant, more is saved for the ultimate consumer and more is produced for the producers in terms of netback. Therefore, the focus is on the netback for the producers at various cost levels.

MR. BOYKIN turned to the benefits of AGPA. First, there is the "Y" line, which saves \$6 billion in AGPA's particular cost model. The aforementioned produces significant cost advantages. Second, AGPA can sell a percentage of the debt on a tax-exempt basis. He acknowledged that the Alaska Railroad Corporation (ARRC) bonds may be used on a tax-exempt basis, although it would require a difficult IRS ruling. Therefore, it was not assumed that the ARRC bonds could be used. However, as a municipal organization, AGPA can use tax-exempt debt as long as the IRS rules on private use are satisfied. Basically, AGPA believes it could obtain tax-exempt debt for about 30 percent of the debt that would be used on this project. More than that can't be used because most of the gas is being used by private entities rather than municipal uses. The tax-exempt debt is worth between \$200-\$400 million a year depending upon how much is actually used. He also noted that AGPA's income is tax exempt. Therefore, the mismatch between depreciation, interest rates, and taxes is eliminated. Mr. Boykin said that most important is that AGPA is charging economic rent of \$370 million for the use of this structure. He explained that 60 percent of the \$370 million goes to the state, 30 percent to all the municipalities on a per capita basis, and 10 percent to equalize energy prices for communities that couldn't take advantage of the pipeline corridor or other pipeline benefits. "The net-net of this is unless our project ends up having a huge cost ... it has to be automatically the lowest cost, implicit tariff because of these advantages," he remarked.

MR. BOYKIN acknowledged that there are issues that need to be addressed; such as how should gas from a pipeline such as this be priced in state. He said there are alternatives on that. For example, the most normal way to price gas for in-state usage is to price at the cost or just under the cost of alternative fuels. Another way, albeit more controversial, would be to take Chicago prices and subtract the transportation costs to Chicago and utilize that as the in-state price. He opined that one of the largest potential benefits is if one can determine a way in which to have relative cost advantage on gas versus the Lower 48, and this is a potential opportunity for that.

MR. BOYKIN turned to the issue of cost overruns. The simple answer that most want is that the state or the producers should handle the cost overruns. However, he didn't believe that to be viable. Indirectly, cost overruns impact the producers much more than the state. Mr. Boykin said he didn't believe it would be typical for the state to undertake backstopping the cost overrun unless the cost overrun was caused by some action at the state level. If the construction is parsed into pieces, the cost of many of the pieces is certain. However, there will be some pieces for which the cost isn't known as well as the weather. Mr. Boykin informed the committees that he has performed some sensitivity studies with regard to what happens with overruns. On port authority's base case of \$1.58 netback to the producers, a \$4 billion overrun reduces the netback to \$1.34. Therefore, he suggested that there's enough in the netback pricing to allow absorption of some very large overruns. The \$4 billion overrun was on top of \$2.7 [billion] of contingency. Mr. Boykin emphasized, "I think that the contingencies that you have in these things are very significant and we all ought to work our tails off to try and mitigate them. If they do materialize, though, it's not necessarily a project killer." Mr. Boykin concluded by offering to provide the committee with the results of different types of inputs that he has acquired from Taylor-DeJongh, Inc.

MR. WALKER commented that for the first time, Alaska has a distinct advantage from the market side. The stability of supply is becoming more important than it was four to five years ago. A number of companies have suggested that there should be a premium attached to the LNG from Alaska. He noted that in most joint ventures the government owns 70 percent and the private sector owns 30 percent. Therefore, the criticism that a quasigovernmental industry shouldn't be involved in this project because that's the typical way it's done. [The tax exempt status] available from the federal government makes this

an extremely profitable project to all of Alaska. As page 25 of the "Alaska Gasline Port Authority February 2004" illustrates, the annual return to the state is \$1-\$2 billion in revenue.

MR. WALKER mentioned that AGPA participated in a round table discussion with US Secretary of Energy Spencer Abraham in Los Angeles. He informed the committees that California consumes 8.5 bcf a day of gas and Alaska reinjects about 6.5 bcf a day of gas. Secretary Abraham said there has to be a way that this need and market opportunity can be filled from Alaska. Mr. Walker acknowledged that although there are issues that have to be resolved, for once Alaska's proximity and temperature is advantageous. In fact, the last 90-120 days have been extremely active and encouraging. He noted that AGPA has entered into one memorandum of understanding (MOU) on a gas receiving facility in California. Furthermore, AGPA has met with a number of the Governor of California's advisors on a number of occasions and have been advised that the offshore [facilities] "have a leg up" with regard to the permitting process.

MR. BOYKIN explained that although AGPA is a governmental entity, it isn't planning on building an infrastructure to manage construction or operate the facility. The aforementioned would be contracted out to other parties. If [the structure proposed by AGPA] were used, the pipeline construction and operation could be managed by an entity such as Enbridge, TransCanada, or MidAmerica. Mr. Boykin clarified that AGPA is trying to create a structure and a situation that produces significant benefits that can be shared between the producers and the ultimate consumer. Mr. Boykin then emphasized the need to take into consideration the value of the liquids that would be taken down the gas line. In AGPA's model, the liquids are worth \$1.75 billion per year. Furthermore, this pipeline has recently been made more viable because on the Lower 48 leg it's now possible to get some contracts on a long-term basis in Chicago, which wasn't possible as recent as a year ago. He noted that public service commissions are now pushing utilities to fix gas prices on a long-term basis and ensure access to gas on a longer-term basis.

SENATOR DYSON related that he is quite impressed by the evolution of the process. He opined that a hub or manifold somewhere in the Interior that allows the distribution of gas to wherever the market dictates is wise. Senator Dyson noted that he was also impressed by AGPA seeing the need to bring gas to Southcentral Alaska. However, he expressed surprise that the major portion of AGPA's plan is the sale of LNG on the Pacific Rim, [which flies] in the face of other experts saying that LNG receiving facilities on the West Coast are slim to none and that the chance to compete against the very low cost LNG will make Alaska's LNG noncompetitive.

MR. BOYKIN explained that the revenue split between the two legs of the project is probably 60:40. As for the market, AGPA is pricing it at \$2.75 at Valdez as the base case. The aforementioned has created a lot of interest around the world. He related his belief that there will be two to three facilities on the West Coast, regardless of what others are saying. The [O'Melveny & Myers] firm is working on three of them and the clients are spending tens of millions on the permitting process. However, he opined that those facilities in California will be offshore. For example, Crystal Energy would use an old abandoned oil platform brace, he predicted. Many of the objections about LNG would be satisfied by putting those facilities off-shore, although he acknowledged that not all [objections] would be met.

MR. BOYKIN related that those heavily dependent on LNG are increasingly becoming concerned with regard to the stability of LNG from some of the countries with much unrest. Also Alaska's proximity [is advantageous] and could result in LNG swaps. In response to concerns regarding the Jones Act, Mr. Boykin emphasized that the ships cannot be produced in the time required under the Jones Act. Therefore, it is believed that a number of the provisions of the Jones Act would be waived. He noted that there has been much support on this from the maritime unions in Alaska, who have said they would work on this to avoid the Jones Act becoming an impediment to the development of LNG and the West Coast.

CHAIR OGAN inquired as to how one gets past the [reality] that the guys with the gas make the rule.

MR. WALKER explained that the first few years of the AGPA was to acquire a relationship and gas from the producers. The focus has been to sell the gas to the market so that the price is known and work all the pieces up to the wellhead, and then make a presentation to the producers. The goal would be to

make an offer to the producers that they can't refuse because the economics would be so strong. Mr. Walker opined that with the structure AGPA has, it will return a higher wellhead than the producers could achieve on their own and it eliminates as much risk to the producers as possible. Therefore, "it's basically to present on a commercial basis, an offer to purchase." The aforementioned has been done in the past with one producer, although it was probably premature because AGPA didn't have all the pieces together.

MR. BOYKIN interjected that as far as he knew no one has made a bona fide offer to the producers. Until that occurs, the response [is unknown].